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DATE: February 18, 2002

LETTER NO: 2002-CU-02

TO: The Board of Directors and Management
of Michigan State-Chartered Credit Unions

SUBJECT: Year-End Statistics – Michigan State Chartered Credit Unions

We use call report information to monitor Michigan State Chartered Credit Unions both individually and as a whole. We have noticed significant changes and trends between the information reported in the December 2001 and December 2000 call reports. This letter addresses some of the differences and areas of concern we have noted in our analysis of year-end statistics.

<u>Summary</u>

Many credit unions continued to experience high asset growth; however, this growth slowed during the second half of 2001. Loan delinquency and net charge-offs increased. Net earnings improved slightly since June 2001, but remain low relative to prior years. Net worth ratios decreased, but remained strong overall. Liquidity improved.

Credit unions also continue to experience changes in their balance sheet structures, including:

- A significant increase in investments, mostly in commercial banks.

- A moderate increase in loans, with a continuing shift from consumer loans to real estate loans.

- A significant increase in share deposits, with a continuing shift from regular share and share draft accounts to money market and certificate of deposit accounts. Individual Retirement Accounts continue to decrease.

The number of credit unions decreased, and for the first time in many years, the number of credit union members did not increase.

Boards of directors and operational management must carefully review their credit union's performance relative to their 2002 goals and prior year results.

Prudent risk management includes identifying potential risks and adverse trends timely, quantifying the potential risks and trends, and taking timely and appropriate steps to manage these risks. Early detection and timely action are fundamental elements of risk management.

A written plan of action should be established when adverse trends are identified. This plan of action serves to document your awareness of the problem and intended actions to control and correct the adverse conditions.

High Asset Growth

The average annualized asset growth rate more than doubled from December 2000 to December 2001, rising from 5.2% to 11.6%. However, asset growth slowed during the second half of 2001. The number of credit unions with 12-month asset growth over 20% had increased from four at December 2000 to 75 at June 2001. By December 2001, the number declined to 26.

Uncertainty in the stock market, a decrease in fixed income investment yields, and a lag in lowering dividend and interest rates by some management teams have made credit union share and deposit accounts more appealing to consumers. Unplanned or poorly managed asset growth can cause operational problems and erode earnings and net worth as a percentage of assets.

Changing balance sheet structures highlight the importance of sound investment and ALM policies to reduce credit unions' exposure to credit and interest rate risks. Your Board and operational management should also review investment custodial agreements and investment ownership rights to minimize risk to the credit union arising from potential disputes.

Increasing Loan Delinquency and Net Charge-Offs

The average delinquency ratio increased from .80% to .92% from December 2000 to December 2001, with the largest increase in credit card delinquency. Net charge-offs to average assets increased from .33% to .38% during the same period. However, both ratios significantly declined during the second half of the year. Your Board and operational management should continue to review and re-evaluate lending procedures and guidelines to ensure the level of credit risk taken is appropriate for your institution.

Low Net Earnings

The average return on assets (ROA) ratio dropped from .96% to .87% from December 2000 to December 2001. The percentage of credit unions reporting a ROA less than .20% dropped slightly, from 15% to 14% between June 2001 and December 2001. However, this is still significantly higher than the eight percent reported at December 2000.

The decrease in ROA was primarily due to rapid asset growth. As percentages of average assets, gross income decreased 24 basis points, cost of funds decreased 18 basis points, operating expenses decreased two basis points, and provision for loan losses (PLL) expense increased four basis points between December 2000 and December 2001.

Decreasing Net Worth Ratios

The aggregate net worth ratio of all Michigan state-chartered credit unions decreased from 11.96% to 11.49% from December 2000 to December 2001. The decrease is due to low net earnings and rapid asset growth, as outlined previously in this letter. While net worth is still strong overall, the decrease is cause for concern.

Conclusion

I hope the information in this letter is helpful in making informed business decisions. Economic changes provide credit union officials both challenges and opportunities. Operating a financial institution safely and soundly requires diligence in risk identification, measurement, and management. Application of sound management practices becomes even more important during a changing economic environment.

Sincerely,

Roger W. Little
Deputy Commissioner